INDEX

CITATIONS

In the Supreme Court of the United States

OCTOBER TERM, 1965

No. 127

UNITED STATES OF AMERICA, PETITIONER

v.

CHARLES E. O'MALLEY, CLAUDE C. ALEXANDER AND PETER G. FARROW, AS EXECUTORS OF THE WILL OF EDWARD H. FABRICE, DECEASED

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE UNITED STATES

OPINIONS BELOW

The memorandum, findings of fact and conclusions of law of the district court (R. 45) are reported at 220 F. Supp. 30. The opinion of the court of appeals (R. 56) is reported at 340 F. 2d 930.

JURISDICTION

The judgment of the court of appeals was entered on October 27, 1964 (R. 62). A timely petition for

rehearing *en banc* was denied on February 8, 1965 (R. 63). The petition for a writ of certiorari was filed on May 10, 1965, and granted on October 11, 1965 (R. 64). The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

QUESTION PRESENTED

The decedent established a series of *inter vivos* trusts, retaining, however, the right (in conjunction with his co-trustees) to determine whether to pay out income from each trust currently to the beneficiary or to accumulate the income and add it to the principal of the trust. Because of this retention of rights by the decedent, the original principal is concededly a part of his gross estate for federal estate tax purposes. The question presented is whether the accumulated income held by the trust as of the time of his death should also be included.

STATUTE INVOLVED

Section 811(c)(1)(B)(ii) of the Internal Revenue Code of 1939, as amended (26 U.S.C. 811(c)(1)(B)(ii) (1952 ed.)), provides in pertinent part:

> The value of the gross estate of the decedent shall be determined by including the value at the time of his death of all property * * * [t]o the extent of any interest therein of which the decedent has at any time made a transfer * * * by trust or otherwise * * * under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death

> * * * the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom * * *.[1]

STATEMENT

Edward H. Fabrice died in 1949 (R. 13). Some years before, he had established a series of five irrevocable trusts for the benefit of his wife and daughters. The trust for the wife (R. 38-44) is typical. Three trustees were named, one of them Fabrice (R. 44). The trustees were authorized, in their discretion, to pay out the trust income to the wife currently (R. 39). But they were also authorized, in their discretion, to retain any part of the trust income; and any income not paid out to the wife at the end of each calendar year was to become part of the principal. The trust was to terminate 25 years from the date of the trust instrument or 21 years after the wife's death, whichever occurred first. If the wife was alive when the trust terminated, the principal (including all accumulated income) would go to her; otherwise, it would go to her descendants, or, if none, to her estate (R. 40). The original property of the trust comprised shares in a closely held Illinois corporation (R. 16, 22). The trust income consisted entirely of dividends declared on the stock held by the trust. Some of the trust income was distributed to the wife, but more than half was accumu-

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[1] The corresponding provision of Section 2036 of the Internal Revenue Code of 1954, as amended (26 U.S.C. 2036 (1964 ed.)) is materially the same.

lated and used to buy additional shares in the corporation. (R. 22-23).

On Fabrice's death, the principal of the trusts had a value of $276,741.16, of which $186,141.16 represented accumulated income, most of which had been used to purchase additional stock in the corporation (R. 15-23, 47, 57). His executors, respondents here, did not include any part of the principal in Fabrice's estate tax return (R. 14, 45). The Commissioner of Internal Revenue determined that the entire value of the trusts should have been included in the return (R. 16, 45-46). Respondents paid the resulting deficiency and brought this action. The district court held (R. 47-51) that Fabrice's taxable estate should include the value on the date of his death of the property he had originally transferred to the trusts—that is, the trust assets less the accumulated income. The court reasoned that Fabrice, by retaining the power (with his co-trustees) to determine whether to pay out or accumulate income, was able "to designate the persons who shall possess or enjoy the property or the income" of the trusts (Section 811(c)(1)(B)(ii), *supra*, pp. 2-3). If the income was paid out currently, the beneficiaries would enjoy it; but to the extent that it was accumulated, it would go to the remaindermen. Respondents did not appeal from this part of the district court's decision, and it is no longer in issue.

On the question whether the accumulated income was also includible in Fabrice's gross estate, the district court agreed (R. 51-52) with the Commissioner that the result should be the same. But noting (R.

51) that the precise question had been "unequivocally decided by our Court of Appeals" against the Commissioner (in *Commissioner* v. *McDermott's Estate*, 222 F. 2d 665 (C.A. 7)), the district court deemed itself bound to hold for the taxpayer. Declining on the ground of *stare decisis* to re-examine *McDermott*, the court of appeals affirmed (R. 56).[2]

ARGUMENT

Introduction and Summary

The purpose and method of the federal estate tax is to lay a tax upon the passage of property at death. Accordingly, the property of the decedent at his death —not what he may have given away or otherwise disposed of during his lifetime—is, in the ordinary case, the subject of the tax. But to effectuate this basic policy, it has been deemed necessary to include in the decedent's gross estate for federal estate tax purposes certain property that the decedent, during his lifetime, transferred out of his immediate ownership. In general, Congress has insisted that to escape the estate tax an *inter vivos* transfer must be absolute; the decedent may retain no string over the transferred property. See, *e.g.*, *Commissioner* v. *Estate of Church*, 335 U.S. 632; *Commissioner* v. *Estate of Holmes*, 326 U.S. 480; *Reinecke* v. *Northern Trust*

[2] *McDermott* was also followed in *Michigan Trust Co.* v. *Kavanagh*, 284 F. 2d 502 (C.A. 6). But it was rejected in *Round* v. *Commissioner*, 332 F. 2d 590 (C.A. 1), and has not been followed by the Tax Court (see *Estate of Round* v. *Commissioner*, 40 T.C. 970, affirmed, 332 F. 2d 590 (C.A. 1)).

Co., 278 U.S. 339. Thus, the Internal Revenue Code makes elaborate provision for transfers which are revocable, or in which the grantor retains a life estate, or reversionary interest, or other rights or interests.[3]

One form of retained control, explicitly dealt with in Section 811(c)(1)(B)(ii) of the Internal Revenue Code of 1939, is the subject of this case: control over who shall enjoy the income from the property transferred. The district court held—and it is not here in issue—that where, as in the present case, the settlor of a trust retains (whether alone or in conjunction with others, and whether in an individual capacity or as trustee) the right to pay out the trust income to the beneficiary or to accumulate it, the principal of the trust remains a part of the settlor's estate for tax purposes. The reason is that when the settlor decides to accumulate trust income, he shifts enjoyment of the income from the income beneficiary to the remaindermen. See *Lober* v. *United States*, 346 U.S. 335, 337.

The contested issue at this stage of the case is whether, like the principal, the accumulated income under such a trust is to be included in the settlor's gross estate. We show that the language and scheme of the statute require that it be included. Accumulated income is property over which the settlor retains the same string that makes the original principal includible, and he makes a transfer of such income within the meaning of the statute every time income

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[3] See 26 U.S.C. 2036-2040 (1964 ed.).

is added to principal at his direction. Thus, the statutory requirements for inclusion in his gross estate are satisfied. We further show that any other result would open a substantial and unjustifiable loophole in the federal estate tax provisions.

THE ADDITION OF INCOME TO THE PRINCIPAL OF THE FABRICE TRUSTS WAS A TRANSFER BY THE SETTLOR OF PROPERTY OVER WHICH HE RETAINED A STRING; HENCE, LIKE THE PRINCIPAL, IT IS SUBJECT TO FEDERAL ESTATE TAX

A. For the accumulated income here to be subject to tax under Section 811(c)(1)(B)(ii) of the Internal Revenue Code of 1939, two conditions must be met: Fabrice must have (1) "made a transfer" of the accumulated income (2) under which he "retained * * * the right * * * to designate the persons who shall possess or enjoy the * * * income therefrom." Certainly, the second of these conditions has been fulfilled. It is conceded that the principal of the Fabrice trusts is subject to federal estate tax by virtue of Fabrice's retention of the power to determine who would enjoy the trust income. Income that the trustees did not pay out was added to, and became a part of, the principal. As such, it produced income which the trustees (just as in the case of any other trust income) were authorized, in their discretion, to pay out or accumulate. Thus, in terms of retention of control, the accumulated income is indistinguishable from the original principal. Since the latter is subject to federal estate tax, so must be the former—if there was a "transfer" of the accumulated income by Fabrice. That is the only real issue.

B. Fabrice reserved in the trust instrument the right to determine enjoyment of the trust income. He exercised this reserved right—and in so doing made a transfer of the accumulated income—every time he determined to retain income in the trust rather than pay it out. When the income arose, it was not yet part of the principal. The trustees could, in their discretion, pay it to the income beneficiary. But they also could, and frequently did, add it to the principal, and its addition to principal was a transfer by the settlor to the trust. We find no basis in the language or policy of the statute for distinguishing a transfer of this kind from any other addition to principal made by the settlor.

The court of appeals reasoned that there was no transfer of the accumulated income by Fabrice because he had no right to its personal enjoyment (R. 58). It was, the court of appeals reasoned, the property of the trusts and not his to transfer. The premise of this reasoning is erroneous. By force of Section 811 (c)(1)(B)(ii), Fabrice's transfer of the original principal to the trustees in trust was, for federal estate tax purposes, incomplete. In contemplation of law, the transfer took effect at his death and all of the property in the trusts was his until he died. The income earned by the trusts was, for federal estate tax purposes, likewise his—just as in the case of any other income from property owned by him. So when he transferred some of the trust income to principal, he was transferring *his* property to the trust. It was

as if he had added to the trust principal additional share of stock that he owned.[4]

To be sure, under ordinary principles of property law Fabrice may not have "owned" either the principal or any of the income of the trusts. But the only concept of ownership relevant here is that of the federal estate tax provisions—under which Fabrice's attempt to divest himself of ownership of the principal by transferring it in trust was concededly ineffectual, and the ownership of the principal, and hence, we submit, of the income therefrom (as it arose) as well, continued in him until his death.

Our contention that an addition of income to principal is a transfer by the settlor within the meaning of Section 811(c)(1)(B)(ii) is supported by the treatment of an analogous problem under the gift-tax provisions of the Internal Revenue Code: a settlor who retains a discretionary power to pay out or accumulate the income of an irrevocable trust makes a transfer for gift-tax purposes whenever he directs the income to be distributed to the income beneficiary or irrevocably accumulated for the benefit of the remainderman. See Lowndes and Kramer, *Federal Estate and Gift Taxes* (1962 ed.), p. 641. It is also

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[4] *Commissioner* v. *Gidwitz' Estate*, 196 F. 2d 813 (C.A. 7), and *Burns* v. *Commissioner*, 177 F. 2d 739 (C.A. 5), which held that accumulations of income on property transferred in contemplation of death were not subject to estate tax, are distinguishable. A gift in contemplation of death is complete when made; the donor retains no string. See *United States* v. *Wells*, 283 U.S. 102, 116-117. Hence, the income from the gift is not his to give. Here, in contrast, the transfer of the principal was incomplete because Fabrice retained a string.

supported by the settled practice of the Internal Revenue Service to value trust assets for estate tax purposes as of the date of death without regard to changes in the trust portfolio made by the trustees.[5] When trust assets are sold and the proceeds are used to acquire additional assets for the trust, the newly acquired assets are treated as having been transferred to the trust by the settlor. We submit that trust income is similarly transferred when the settlor decides to accumulate it.

In addition, the apparent rationale of the transfer requirements of Section 811(c)(1)(B)(ii) is to exclude from the settlor's gross estate property added to the trust not by him but by a third party. No third party was the source of the additions to principal resulting from the retention of trust income here, and no discernible policy, therefore, would be served by holding—in the teeth of the language and scheme of the statute—that there was no transfer by Fabrice.

C. Not only is the result reached by the court of appeals without basis in the statute; it opens up a substantial loophole. Suppose that the controlling stockholder in a closely held, family corporation desires to avoid a heavy estate tax, but on the other hand does not wish to lose complete control of any substantial part of his property, as he would by

[5] See *Lober* v. *United States*, 346 U.S. 335; *Estate of Guggenheim* v. *Commissioner*, 40 B.T.A. 181, affirmed, 117 F. 2d 469 (C.A. 2), certiorari denied, 314 U.S. 621; *Holderness* v. *Commissioner*, 33 B.T.A. 155, affirmed, 86 F. 2d 137 (C.A. 4); Montgomery, *Federal Taxes, Estates, Trusts and Gifts* (1951-1952), pp. 626-630.

transferring it outright to members of his family. He therefore establishes a trust and transfers to it most of his stockholdings; but he retains control over the enjoyment of the trust property or income. He cannot, of course, avoid a federal estate tax on the original principal of the trust, because he has not relinquished control over it. But, since the trust is composed of shares in a corporation he controls, he can manipulate the value of the original principal so as to minimize the federal estate tax liability. If during his lifetime the corporation retains most of its earnings, the value of the stock, and hence of the original principal of the trust, will be relatively high at the date of his death; and that will be the value includible in his gross estate. But he need not retain earnings. If, instead, he pays out all of those earnings in the form of dividends,[6] and then accumulates the trust income, adding it to the principal, the value of the trust will presumably be the same at his death as if the earnings had been retained in the corporation, but under the theory of the court of appeals only a part of it—represented by the original principal—will be subject to federal estate tax. In addition, he can postpone the payment of any dividends until after the trust is established, with the result that the value of the trust when he dies will be represented largely by accumulated income (not subject to estate tax under the view of the court

[6] As evidently happened here: the value of each share of stock in the closely held corporation was the same at the creation of the trusts as at Fabrice's death 12-13 years later (R. 14).

of appeals) rather than original principal (which is so subject).

We find no basis for imputing to Congress an intent to create such an opportunity for tax avoidance by the manipulation of stock in a closely held corporation. The value of the decedent's estate, for federal tax purposes, is the value of the property includible in the estate at the date of his death. If the decedent establishes a trust consisting of shares of stock in a corporation he controls, and decides to retain the earnings in the corporation, the retained earnings will be reflected in the value of the stock; and hence both the original value of the stock and the value of the retained earnings will be includible if, as here, he has retained a string over the property transferred in trust. If, instead, he decides to distribute the earnings as dividends, but then retains the dividends in the trust, the effect is precisely the same; and we submit that the estate tax consequences should also be the same.

CONCLUSION

For the foregoing reasons, the judgment of the court of appeals should be reversed.

Respectfully submitted.

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